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TOO BIG TO FAIL; If a major bank slips into deep trouble, Uncle Sam may have to help save it

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It's the question bank regulators dread: Should they bail out a crucial bank if it collapses?

With economic and market conditions sliding precipitously, risk is rising fast that at least one major institution could implode, endangering the financial system with it. The way the Federal Reserve and other government watchdogs deal with a blowout could determine how much damage is left by the current credit crisis.

With banks getting battered on a number of fronts, the odds of an outright failure are higher than they've been in years. Troubled ones are discovering that the protection they bought from bond insurers, including Ambac and ACA Capital, for subprime and other securities is inadequate. Given the problems in that industry, on Jan. 23 New York State regulators met with major investment banks as part of an effort to stabilize bond insurers, which guarantee about $800 billion of complex financial products such as mortgage-backed securities and collateralized debt obligations (CDOs).

Banks may face more pain from commercial real estate loans, credit cards, and corporate loans, all of which show signs of weakness. Loans to highly leveraged hedge funds that bet heavily on global stocks are also in jeopardy. Meanwhile, housing prices remain unstable, a situation that continues to work its way through the food chain of mortgages, mortgage-backed bonds, and CDOs. So there could be more big losses.

With those dangers piling up, it's not hard to imagine the possible trigger for bankruptcy: Worried about all these problems, lenders could easily demand repayment from a big bank, creating a crisis. And if the casualty is any one of about a dozen U.S. commercial banks or a handful of other prominent financial players, regulators would probably feel compelled to fashion some kind of bailout to keep the damage from spreading to the broader financial system.

Although today's rescues aren't likely to be all-encompassing, the basic philosophy is rooted in the bailout of Continental Illinois National Bank & Trust, which failed in 1984 after bad bets on energy loans. In that case, the government agreed to make everyone whole, including stockholders, bond investors, and uninsured depositors. The broad rescue enraged other banks and taxpayers, and prompted a congressional investigation. In the aftermath, a Treasury official admitted he would have made the same deal for any of the 11 biggest national banks in an effort to protect the stability of the financial system.

Ever since, analysts have speculated on which banks are deemed "too big to fail"--an implicit government guarantee that factors in the grades that ratings agencies such as Moody's assign the biggest banks.

BREAKING IT UP

If such drastic action is necessary this time, expect a smaller-scale bailout. The government might facilitate private loans or investments from outside players to prop up a bank temporarily, as it did with busted hedge fund Long-Term Capital Management in 1998. Or the feds might simply take over the bank and sell it off in pieces, which shelters depositors and creditors from sudden and complete loss but wipes out equity investors. That's what happened with the Bank of New England, the regional giant that collapsed in 1991 under the weight of bad loans in commercial real estate. Alternatively, some observers suspect, regulators might relax certain capital requirements, allowing a weak bank to stay in business and heal itself.

No matter how, or if, such scenarios play out, one thing is certain: Central bankers hate bailouts. In particular, they loathe helping an individual institution even more than they dislike creating general economic bailouts via interest rate cuts and increased government spending. Both, in effect, ratify the excesses that lead to a bust and encourage more wasteful behavior in the future. But deals for specific banks are especially bothersome because they pardon individuals for bad decisions.

Regulators can take a lot of flak for such moves, too. During the savings and loan crisis in the 1980s, critics lambasted the government for not supervising the banks properly in the first place and then for passing out aid to the ones headed by politically well-connected individuals. Central bankers face a dilemma, says veteran economist Henry Kaufman of consulting firm Henry Kaufman & Co., in choosing whether to save the day or enforce financial discipline.

Of course, the threat of a big bank failure today may subside. The government's latest rate cuts and additional spending programs may boost the economy and banks' balance sheets. And banks already are replenishing their coffers with more than $20 billion from sovereign wealth funds.

"AGGRESSIVE POLICY RESPONSE"

But the high cost of oil, the weak dollar, and falling house prices continue to cloud the outlook. And hot spots are flaring that could worsen the crisis. Bond insurers, for example, are taking huge hits on subprime exposure. One risk is that the insurers' woes will spill over into the municipal bond market, since state and local governments depend on insurers to back the bonds they issue for roads and other projects. Any success New York regulators have in attracting capital to the bond-insurance industry would help solve the muni problem and limit the need for a government-funded bailout. "There needs to be an aggressive response," says Christian Stracke, a senior analyst at research service CreditSights. "It is very urgent."

The government's take on bailouts has evolved over the years. The public decried Washington's intervention in the 1980s, a period marked by hundreds of rescues of savings and loans that liberally spread government largesse. So in 1991, Congress passed a law stipulating that broken banks could be fixed only at the "least cost" to taxpayers, generally by covering only insured deposits of up to $100,000.

But the law gave regulators a loophole. It allows bigger bailouts if top officials, in consultation with the President, decide they are necessary to prop up the financial system. That clause has yet to be tested. But then again, no big banks have failed in the 16 years since the law was passed.

Regulators have also increased scrutiny of the biggest financial firms, reducing chances of a bailout. The Fed, for instance, runs computer simulations of failures to determine which banks perform certain critical functions in the financial system. After such an analysis two years ago, the Fed sanctioned procedures to launch a cooperative bank quickly in the event that JPMorgan Chase or Bank of New York, the two leaders in clearing trades of U.S. bonds, ran into trouble.

The Federal Deposit Insurance Corp., meanwhile, has tuned up its procedures so it can quickly make good on insured deposits. FDIC Chairman Sheila C. Bair said in a speech before the problems surfaced that, as result of all the changes, she "would be hard-pressed to envision a scenario" in which the government grants significant bailouts to a wider pool of creditors and investors.

Still, a new round of bailouts would likely breed more. Gary H. Stern, president of the Federal Reserve Bank of Minneapolis and author of Too Big to Fail: The Hazards of Bank Bailouts, says that the seeds of today's woes may well have taken root during previous interventions. He believes the banks would have curbed some of their bad lending practices and risky subprime investment decisions if they didn't have implicit guarantees of a government safety net. It's not unlike what Federal Reserve Chairman Ben S. Bernanke said about bailouts back in April when he pronounced that bank investors "must be...persuaded that they will experience significant losses in the event of failure." Otherwise, he said, it's all too easy for bank executives to waste money on bad loans.

But the tough-love approach, concedes Stern, can only be used during periods of stability: "When you're dealing with financial turbulence, you've got to deal with the problem at hand."

THE TOP 10

The government won't say which banks are so critical to the financial system that it would step in to bail them out if necessary. But here's how Moody's rates the odds of a rescue for these banks if they get in a bind:

BANK	CHANCES OF GOVERNMENT SUPPORT
Bank of America	very high (70% to 95%)
Bank of New York	very high
Citigroup	very high
JPMorgan Chase	very high
State Street	high (50% to 70%)
U.S. Bancorp	high
Wachovia	high
Wells Fargo	high
SunTrust Banks	low (up to 30%)
Washington Mutual	low

Data: Moody's Investors Service